FILE COPY

Office - Supreme Court, U. S.
FILED
MAR 27 1947
CHARLES ELMORE CROPLEY
CLERK

No. 1067

In the Supreme Court of the United States

OCTOBER TERM, 1946

JOHN C. CLEAVER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	3
Argument	4
Conclusion	9

CITATIONS

Cases:

Alsberg v. *Commissioner*, 42 B. T. A. 61	9
Burgess v. *Commissioner*, 8 T. C. No. 5	9
Celina Manufacturing Co. v. *Commissioner*, 142 F. 2d 449	8
Chatham & Phenix National Bank v. *Commissioner*, 1 B. T. A. 460	9
Dobson v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231	9
Eckert v. *Burnet*, 283 U. S. 140	5, 8
Fleckner v. *United States Bank*, 8 Wheat. 338	6
Hart v. *Commissioner*, 54 F. 2d 848	5, 7
Helvering v. *Price*, 309 U. S. 409	5
Hirsch v. *Commissioner*, 42 B. T. A. 566	5, 9
Keith v. *Commissioner*, 139 F. 2d 596	5
Konigsberg v. *Commissioner*, decided January 22, 1946	9
Mass. Mutual Life Ins. Co. v. *United States*, 288 U. S. 269	4, 8
Musselman Hub-Brake Co. v. *Commissioner*, 139 F. 2d 65	7, 8
O'Day v. *Commissioner*, 20 B. T. A. 454	5
Prime v. *Commissioner*, 39 B. T. A. 487	5, 9
Solof v. *Commissioner*, 1 B. T. A. 776	5, 9
Thomason v. *Commissioner*, 33 B. T. A. 576, appeal dismissed April 29, 1937	5
United States v. *Mitchell*, 271 U. S. 9	4

Statute:

Internal Revenue Code:

Sec. 23 (26 U. S. C. 1940 ed., Sec. 23)	2, 4
Sec. 43 (26 U. S. C. 1940 ed., Sec. 43)	2

736404—47

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 1067

JOHN C. CLEAVER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 24–27) is reported at 6 T. C. 452. The opinion of the Circuit Court of Appeals (R. 48–51) is reported at 158 F. 2d 342.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 3, 1946. (R. 52.) The petition for certiorari was filed February 27, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the petitioner paid "interest" within Section 23 (b) of the Internal Revenue Code and may take a deduction therefor when, at the time he secured three bank loans, he gave the bank notes for an amount including interest as well as the sum actually credited for his use by the bank, and the latter treated the interest as paid in advance.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.
>
> * * * * *
>
> (26 U. S. C. 1940 ed., Sec. 23.)
>
> SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.
>
> The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or

incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1940 ed., Sec. 43.)

STATEMENT

The facts as found by the Tax Court (R. 25) are as follows:

In 1941, the petitioner used his personal account with the Cleaver-Brooks Company of Milwaukee, Wisconsin, to purchase three policies of single premium life insurance and repaid that company by borrowing money from the Marine National Exchange Bank of Milwaukee. In connection with these loans, the petitioner gave the bank three notes, each due five years after date and each expressly providing that interest should be paid in advance at the rate of two and one-fourth per-cent per annum. (R. 25.)

The bank computed interest for five years at two and one-fourth percent on the principal amount of each note and deducted the interest so calculated from the principal amount of each note, making available to petitioner the balance as follows (R. 25):

Amount of loan	*Interest deducted*	*Net loan proceeds*
$23,400	$2,632.50	$20,767.50
23,400	2,632.50	20,767.50
22,150	2,491.88	19,658.12
68,950	7,756.88	61,193.12

The bank credited the sum of $7,756.88 to reserve account known as "interest or discount collected in advance," and it then each day took therefrom the amount of interest earned and credited it to its earning account. (R. 25.)

The petitioner reported his income for federal tax purposes on the cash basis. (R. 25.)

The Tax Court held that no interest was deductible by the taxpayer in 1941 and decided that there was a deficiency in income tax in the amount of $3,060.53. (R. 27.) This decision was affirmed by the Circuit Court of Appeals for the Seventh Circuit. (R. 48–52.)

ARGUMENT

The question of whether a taxpayer on the cash basis is entitled to a deduction for "interest" under Section 23 (b) of the Internal Revenue Code must be considered in the light of the general principle of tax law that taxpayers on the cash basis, like petitioner here, may take into account, in making their income tax return, only amounts actually received and amounts actually put out in cash or its equivalent. *United States* v. *Mitchell,* 271 U. S. 9; *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269. The word "paid", as used in Section 23 (b) has been given its generally understood and ordinary meaning. Thus, to entitle one to a deduction for interest, a payment must be in cash or its equivalent, and the giving of a note does not constitute such a pay-

ment. *Hart* v. *Commissioner,* 54 F. 2d 848 (C. C. A. 1st); *Keith* v. *Commissioner,* 139 F. 2d 596 (C. C. A. 2d); *Thomason* v. *Commissioner,* 33 B. T. A. 576, appeal dismissed April 29, 1937 (C. C. A. 7th); *Alsberg* v. *Commissioner,* 42 B. T. A. 61; *Hirsch* v. *Commissioner,* 42 B. T. A. 566; *Prime* v. *Commissioner,* 39 B. T. A. 487; *O'Day* v. *Commissioner,* 20 B. T. A. 454; *Solof* v. *Commissioner,* 1 B. T. A. 776. See also *Helvering* v. *Price,* 309 U. S. 409; and *Eckert* v. *Burnet,* 283 U. S. 140, in which taxpayers on a cash basis were not permitted to take deductions for losses in the year when they gave notes with which "to pay" liabilities incurred by them as guarantors.

The Tax Court's conclusion that there was no payment of interest by the petitioner during the taxable year is based on the following findings: (1) As a result of the three loans to petitioners, the bank made $61,193.12 available to him; (2) the bank also credited $7,756.88 to a reserve account known as "interest or discount collected in advance" on these loans, and daily subtracted from such reserve account the amount of interest earned and credited it to the earnings account; and (3) the petitioner gave the bank three promissory notes aggregating $68,950, i. e., $61,193.12 plus $7,756.88. (R. 25.) The petitioner here, having given the bank nothing but its promises to pay in the future, did not pay interest in cash or its equivalent when the loans were made.

But petitioner contends that the term "discounting" means payment in advance, and so in effect argues that we must ignore the facts here because the notes were "discounted." It is, of course, true that in discounting notes, banks treat the interest as paid in advance; but it is equally true that in tax matters we are required to look through formal devices and bookkeeping entries to the real substance of a transaction. When this is done, it is evident that there was in fact no payment here in cash or its equivalent. Instead, the petitioner gave three promissory notes and the bank made some bookkeeping entries including a credit for interest to a special reserve account. Obviously a credit for interest under these circumstances is not proof of actual payment of interest in cash or its equivalent, regardless of how the matter is handled for bookkeeping purposes.

Petitioner is in error in contending that the Tax Court has misapplied *Eckert* v. *Burnet,* 283 U. S. 140. As indicated above, that case involved a loss. Nevertheless, the general principle announced therein is applicable here inasmuch as the Court there held, in substance, that taxpayers on the cash basis who give notes in satisfaction of debts do not "pay" such debts for income tax purposes when notes are given but that payment is made when the debtor parts with cash or its equivalent. The fact that a bank may treat the interest as paid by entering a credit on its books does not establish a cash payment entitling the taxpayer to

a deduction for interest. *Hart* v. *Commissioner,* 54 F. 2d 848, 852 (C. C. A. 1st).

There is no conflict in the authorities on this issue. *Musselman Hub-Brake Co.* v. *Commissioner,* 139 F. 2d 65 (C. C. A. 6th), cited by the petitioner (Pet. 4), involved a taxpayer on the accrual basis. The deductions there sought, consisting of patent royalties and interest, were accrued on the taxpayer's books and the taxpayer's creditor was given demand promissory notes for the amount so accrued. It was held that these notes had a readily realizable value equal to par and the creditor included the amounts as income in his return for the year of receipt. The only question was whether the taxpayer's right to a deduction of such amounts under Sections 23 (a) (1) and (b) of the Revenue Act of 1938, c. 289, 52 Stat. 447, as ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business and as interest accrued during the taxable year, should, although otherwise allowable, be denied because of the provisions of Section 24 (c) of the Revenue Act of 1938 which disallowed deductions by certain classes of taxpayers for incurred expenses and accrued interest if such amounts were not paid within the taxable year, or within two and one-half months after the close thereof, and if by reason of the method of accounting of the person to whom the payment is to be made the amount thereof was not, unless paid, includible in the gross income of such person

for the taxable year in which the taxable year of the taxpayer ends. In that case the Court narrowly construed Section 24 (c), which was designed to prevent tax avoidance, in the light of its legislative history as requiring payment only in such form that the creditor would be required to include the sums in his gross income.

The present case does not involve Section 24 (c) and the taxpayer here was on the cash basis of accounting; he parted with neither cash nor its equivalent but merely gave a promise to pay in the future. In the *Musselman Hub-Brake Co.* case the court's distinction (pp. 68–69) of *Eckert* v. *Burnet*, *Helvering* v. *Price*, and *Mass. Mutual Life Ins. Co.* v. *United States*, *supra*, shows clearly that the court did not consider its decision as conflicting with the general principle that a taxpayer on the cash basis may not deduct amounts which are not paid out in cash but which are merely represented by a promise to pay evidenced by a note.

The case of *Celina Manufacturing Co.* v. *Commissioner*, 142 F. 2d 449 (C. C. A. 6th) cited by the petitioner (Pet. 16), was like the *Musselman Hub-Brake Co.* case, and is likewise distinguishable from the present case.

Furthermore, if the question should be treated as primarily an accounting matter, then the issue is one for the Tax Court, since accounting matters are peculiarly within its province. *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied,

321 U. S. 231. On the issue here, the decisions of the Tax Court show a well established policy to permit deductions for interest only when actually paid in cash or its equivalent. See *Alsberg* v. *Commissioner*, 42 B. T. A. 61; *Prime* v. *Commissioner*, 39 B. T. A. 487; *Hirsch* v. *Commissioner*, 42 B. T. A. 566; *O'Day* v. *Commissioner*, 20 B. T. A. 454; and *Solof* v. *Commissioner*, 1 B. T. A. 776. Also cf. *Chatham & Phenix National Bank* v. *Commissioner*, 1 B. T. A. 460. Petitioner cites *Burgess* v. *Commissioner*, 8 T. C. No. 5, and *Konigsberg* v. *Commissioner*, decided January 22, 1946 (1946 P–H T. C. Memorandum Decisions, par. 46,024), but these cases are distinguishable on their facts and do not show any departure from the Tax Court's other decisions.

CONCLUSION

The decision below is correct, and there is no conflict in the decisions. The petition should be denied.

Respectfully submitted,

GEORGE T. WASHINGTON,
Acting Solicitor General.
SEWALL KEY,
Acting Assistant Attorney General.
LEE A. JACKSON,
LOUISE FOSTER,
Special Assistants to the Attorney General.

MARCH 1947.

U. S. GOVERNMENT PRINTING OFFICE: 1947